

HUNTON & WILLIAMS USAID UKRAINE

ENERGY LEGAL, REGULATORY AND MARKET REFORM PROJECT

REGULATORY AUTONOMY, AUTHORITY AND ACCOUNTABILITY A COMPARISON OF THE KEY CHARACTERISTICS OF REGULATORY COMMISSIONS WITH UKRAINE'S NERC BILL

Prepared for:



U.S. Agency for
International Development

IQC No:

EEU-I-00-99-00033-00

Task Order No:

OUT-EEU-I-800-99-00033-00

July 18, 2001

**REGULATORY AUTONOMY, AUTHORITY AND ACCOUNTABILITY
A COMPARISON OF THE KEY CHARACTERISTICS OF REGULATORY
COMMISSIONS WITH UKRAINE'S NERC BILL**

July 18, 2001

The following Chart compares the bill "On the Bases of the State Regulation of Natural Monopolies and Related Markets in the Fuel and Energy Complex of Ukraine" ("NERC Bill") to the key characteristics needed to provide a regulatory body with substantial autonomy from short-term political and other interventions, adequate authority to establish sound regulatory practices and clear accountability to assure transparency and credibility. As will be seen, while the NERC Bill pending a second reading in the Verkhovna Rada is not perfect, it does contain most of the key characteristics needed for a sound, transparent and stable regulatory body and regulatory procedures.

I. CHARACTERISTICS OF AUTONOMY	UKRAINE'S DRAFT LAW
<p>Autonomy can be enhanced by the following measures that provide commissioners reasonable protection and allow economic decision-making and consideration of social issues. Autonomy is desirable to put some distance between the regulator and government, utility companies and the public.</p>	
<p>1. <u>Appointment of Commissioners</u></p> <p><u>Staggered Terms</u>: Commissioners should be appointed on staggered terms that cross election cycles. This allows for gradual change of regulatory policy when a new Government takes office. For example, 5 commissioners can initially be appointed for 1, 2, 3, 4 and 5 years so that one appointment is made per year. This allows a new government to make 3 appointments (a majority) in 2 years and 1 day.</p>	<p>Art. 6: ¶ 3 The National Energy Regulatory Commission ("NERC") shall be composed of 5 commissioners. ¶ 4 Their tenure is 6 years long and they are periodically rotated. The procedure for rotation shall be established by the Provisions on the National Regulatory Commission of the Natural Monopolies and Related Markets in the Fuel and Energy Complex of Ukraine. ¶ 5 The same person can not serve over two consecutive terms on the Commission.</p> <p>Art. 8: ¶ 13 After the end of his tenure, the Commission's Chairman continues to fill the position until another is appointed.</p> <p>§ IV ¶ 3 Cabinet of Ministers of Ukraine, prior to this Law's effective date, shall develop and introduce the succession procedure for NERC.</p>

<p><u>Quality Criteria:</u> Initially it is useful to make professional appointments including people with background and training in economics, finance, law and engineering. To minimize the risk of being “captured” by the power industry, there may be some restrictions on the number of commissioners that have previously worked in the power industry which is being regulated.</p>	<p>Art. 7: ¶ 4 Commission members shall have higher education and experience in economics, energy and law during no less than 5 of the past 10 years. ¶ 5 The Chairman, commissioners or persons related to them should have no direct or indirect financial interests, economic or political connections to the regulated firms. ¶ 6 Presence of such connections constitutes grounds for removal. ¶ 7 Any influence on the Chairman or Commissioners shall be prohibited. ¶ 8 Commissioners shall not work and/or be paid a salary (rewards) at the regulated firms, within one year after resignation.</p>
<p><u>Who Makes Appointments:</u> A high level executive branch official can appoint, e.g., the President or Prime Minister. They have a broader view and responsibility. Approval by the Cabinet or Parliament has disadvantages and advantages.</p>	<p>Art. 2: ¶ 3 NERC is a central body of the executive and is created and liquidated by the President.</p> <p>Art. 8 ¶ 12: The Chairman shall appoint a replacement for himself in his absence.</p>
<p>2. <u>Exemption from Civil Service/Government Salary Rules</u></p> <p>The commissions should have a salary scale separate from the civil service in order to attract skilled commissioners and staff who have significant responsibilities for tariff formulation, legal interpretations and sector monitoring. The scale should be competitive with the private sector and regulated companies.</p>	<p>Art. 14: ¶ 2 NERC Commissioners and employees’ salaries shall be annually established by Verkhovna Rada.</p>
<p>3. <u>Financing the Commission; License Fees and Budget Approval</u></p> <p><u>License fees:</u> License fees on the regulated companies provide a steady source of revenue for operations of the commission. Going through the standard budgetary process through the government and the parliament subjects the commission to pressures and threats of unjustified reductions. A separate bank account outside the state budget provides autonomy.</p>	<p><i>(Note: Providing funding from fees and having a separate bank account violates the Ukrainian Constitution.)</i></p> <p>Art. 14: ¶¶ 1-2 NERC shall be financed as part of the State budget, which will include a separate line item. ¶ 2 NERC financing shall be established annually by Verkhovna Rada.</p> <p>Art. 8: ¶ 6 The Chairman shall draft a cost estimate for maintaining the NERC.</p>

<p>Budget Approval: The review of the commission's annual budget can be done at a high level such as the Prime Minister or President rather than the ministry level or the parliament. With no state funds involved, it is not necessary to have standard government or parliamentary budget review. (However, government and parliamentary oversight of operations and results in appropriate; see below under Accountability.)</p>	<p>Art. 14: ¶¶ 1-2 NERC shall be financed as part of the State budget, which will include a separate line item. ¶ 2 NERC financing shall be established annually by Verkhovna Rada.</p>
<p>4. <u>Removal from Office for Cause Only:</u> To provide stability and consistency commissioners should only be removed for cause, i.e., criminal behavior, significant violation of code of ethics, or failure to participate in majority of regulatory meetings. Laws on regulation should spell out the circumstances under which a commissioner can be removed and who has authority to do it. It is reasonable to have the same person carry out removal as did the appointment.</p>	<p>Art. 6: ¶ 8 Commissioners may be terminated if they violate Article 11. Article 11 ¶ 2 provides that the NERC shall perform its duties in compliance with the Ukrainian Constitution and laws independent of central and local state executive power bodies, power bodies of the Autonomous Republic of Crimea, local and regional self-governing bodies, their officials and public associations.</p> <p>Article 6 ¶ 8 also provides that the President could terminate a member of the Commission based on a vote of no confidence by Verkhovna Rada.</p>
<p>II. CHARACTERISTICS OF AUTHORITY</p>	
<p>1. <u>Full Tariff Authority:</u> The commission should have full authority over tariff setting. Review and/or approval of tariffs by a government ministry subjects tariffs to short-term political influence that is undesirable based on experience in most countries. Government interests can be addressed through the appointment process and through participation in commission public hearings.</p>	<p>Art. 5: ¶ 7 One of the major tasks of the NERC shall be formation of pricing and tariff policy.</p> <p><i>(Note: Tariff approval authority is not specifically listed in Article 9 under NERC's functions.)</i></p>

<p>2. <u>License Issuance:</u> The commission should have full authority to issue licenses for long terms. Long terms are essential for providing stability so investors can make necessary investments to upgrade operations and be reasonably assured they will have time to earn a profit on their investment.</p>	<p>Art. 10: ¶ 1 The procedure for issuing licenses shall be determined by the Cabinet of Ministers, based on the recommendations of NERC. ¶ 2 The Commission shall decide to issue or refuse a license within 30 days of receiving the license application. ¶ 5 The term of the license shall be determined by the Commission. In determining the term of the license, the Commission shall consider the time required to recover the licensee's capital investment, and cannot be less than three years.</p> <p><i>(Note: It is unclear whether the NERC establishes the level of the licenses.)</i></p>
<p>3. <u>Electricity Market:</u> The commission could have a significant role in the strategy, design and oversight of electricity market reforms. The extent of authority can vary from holding hearings, publication of guidance, review of proposed market arrangements to actual drafting of proposed market structures.</p>	<p>Art 5: The major tasks of the NERC shall be, among other things: ¶ 3 State regulation of entrepreneurial activity in the energy markets; ¶ 4 Promotion of competition in the sphere of electricity generation with the aim of ensuring efficient operation of the relevant industries and efficient utilization of energy resources; ¶ 5 Securing electricity customers right to get products and services of standard quality at economically substantiated prices;</p> <p>Art. 9: NERC shall, among other things: ¶ 1 Develop and approve special conditions and rules for carrying out electricity generation, transmission and supply; ¶ 2 Issue licenses for electricity generation, transmission and distribution; ¶ 3 Identify criteria allowing entrepreneurial entities to generate electricity in small amounts without licenses; ¶ 4 Approve the Wholesale Electricity Market Algorithm; ¶ 12 Take part in establishing rules for the operation of the Wholesale Electricity market and in the control over their observance;</p> <p>Art. 12: ¶¶ 1-3 At its sessions, which are to be carried out publicly, the NERC shall consider and decide cases within the Commission's competence; ¶ 4 Approve, within the scope of its competence, drafts of legislation on the improvement of the Ukrainian law, consider proposals regarding improvement of current electricity law; ¶ 6 Consider cases of the</p>

	regulated firms' observance of license rules and conditions and of the use of property sanctions for the violation of the law.
<p>4. <u>Information Collection Monitoring and Enforcement</u>: The commission needs authority to monitor utility performance and enforce remedies such as penalties for non-compliance with license provisions. They should also have the authority to establish quality of service standards to be met by the utilities. The commission's monitoring functions must be clearly defined as well as those of the anti-monopoly, environment and nuclear regulatory bodies.</p>	<p>Art. 9: NERC shall, among other things, ¶ 8 Consider cases regarding license violations and make relevant decisions, within its competence, based on the results of its investigation; ¶ 9 Monitor cross-subsidization by licensees; ¶ 13 Take measures to insure equal rights of access for all market entities of electricity, oil, gas and oil products; ¶ 20 Ensure the observance of license rules and conditions.</p> <p>Art. 10: ¶ 2 The Commission shall decide whether a licensee has violated the terms of the license. ¶ 8 In the event of repeated or gross violations by a licensee, the Commission shall impose fines in accordance with Article 17. ¶ 9 Sanctions shall be used according to the procedure envisioned by the Cabinet of Ministers.</p> <p>Art. 12: ¶ 6 NERC shall consider whether a licensee has observed licensed rules and conditions and shall consider of the use of property sanctions for violation of the law.</p> <p>Art. 13: ¶ 10 Decisions of the commission shall be binding and effective upon issuance.</p> <p>Art. 2: ¶ 4 The decisions of the NERC shall be binding for all business entities in the fuel and energy complex.</p> <p>Art. 17: ¶¶ 1-3 Penalties shall be imposed on regulated entities for failure to fulfill a decision of the NERC, failure to submit information to NERC or submission of deliberately false information to NERC.</p>

III. CHARACTERISTICS OF ACCOUNTABILITY

1. **Public Participation and Transparency:**

Procedures for public hearings, a public record of submission and public access to written decisions are necessary. Through this process the views of government, utilities companies, citizens and citizen organizations can be expressed.

Art 1: ¶ 7 A principle of this legislation is the transparency and publicity of the energy regulation process.

Art. 9: ¶ 15 NERC shall inform the public about its work, carry out publishing activity in accordance with the procedure set forth by law; ¶ 16 NERC shall submit reports to the President and publish annual reports on its activity. ¶ 17 NERC shall report annually to Verkhovna Rada.

Art. 12: ¶ 1 Sessions of the NERC shall be the main form of the NERC's work and have to be carried out publicly and openly.

Art. 13: ¶ 2 The Commission should explain the reasons for its decisions. The decision making procedure shall account for the following rights of all parties: ¶ 3 Notification on the proposed action of the Commission at least 5 days in advance; ¶ 4 Ability to present its own views; ¶ 5 Ability to submit evidence ¶ 6 Ability to respond to evidence of other parties; ¶ 8 Decisions and their substantiation shall be submitted to all interested parties. Decisions of great social significance shall be published in the mass media.

2. **Annual Report and Audit:** An annual report of activities including an international financial audit should be required. This will provide a high level of accountability and creditability to the domestic and international interests. This report can be accompanied by appearance before the appropriate parliamentary committees.

Art. 6: ¶ 6 NERC shall report its work annually to Verkhovna Rada.

Art. 9: ¶ 15 NERC shall inform the public about its work, carry out publishing activity in accordance with the procedure set forth by law; ¶ 16 NERC shall submit reports to the President and publish annual reports on its activity. ¶ 17 NERC shall report annually to Verkhovna Rada.

<p>3. <u>Appeal of Decisions to Courts Only or International Arbitration</u>: Appeal of tariff and license decisions should only be to the courts and limited cases based on errors of fact or procedure. Issues of market power may be shared or appealed to the anti-monopoly organization. For international investors, some issues may be made subject to international arbitration.</p>	<p>Art. 13: ¶ 10 Decisions of the commission shall be binding upon issuance. Disagreement with a Commission decision can be appealed to the Antimonopoly Committee, the Court and the Court of Arbitration.</p>
<p>4. <u>Budget Review</u>: The review of the budget level (and license fees) by either the President or Prime Minister provides a check on the development of excessive budgets.</p>	<p>Art. 14: ¶¶ 1-2 NERC shall be financed as part of the State budget, which will include a separate line item. ¶ 2 NERC financing shall be established annually by Verkhovna Rada.</p> <p>Art. 8: ¶ 6 The Chairman shall draft a cost estimate for maintaining the NERC.</p> <p><i>(Note: It is unclear whether NERC establishes the level of the license fees.)</i></p>

<p>5. <u>Code of Ethics:</u> Commissions should develop a code of ethics governing commissioner and staff behavior. This provides a clear basis for action against improper behavior.</p>	<p>Art. 7: ¶ 2 The Chairman and Commissioners shall have professional qualities required to make independent decisions and resist improper pressure or incentives. ¶ 5 The Chairman, commissioners or persons related to them should have no direct or indirect financial interests, economic or political connections to the regulated firms. ¶ 6 Presence of such connections constitutes grounds for removal. ¶ 7 Any influence on the Chairman or Commissioners shall be prohibited. ¶ 8 Commissioners shall not work and/or be paid a salary (rewards) at the regulated firms, within one year after resignation.</p> <p>Art. 11: ¶ 2 Central and local state executive power bodies, power bodies of the Autonomous Republic of Crimea, local and regional self-governing bodies, their officials and public associations are prohibited from intervening in the activity of the NERC, except when this attempt is made publicly and follows the NERC procedure on public participation in discussing draft decisions.</p> <p>Art. 17: ¶ 8 NERC officials shall be responsible for improper fulfillment of their duties including divulging confidential information.</p>
<p>6. <u>Removal from Office - for Cause Only:</u> The inclusion in a regulatory law of clearly defined specific actions that can lead to removal makes commissioners and staff accountable for their behavior. This provides a sound basis for removal of specific causes and not political reasons.</p>	<p>Art. 6: ¶ 8 Commissioners may be terminated if they violate Article 11. Article 11 ¶ 2 provides that the NERC shall perform its duties in compliance with the Ukrainian Constitution and laws independent of central and local state executive power bodies, power bodies of the Autonomous Republic of Crimea, local and regional self-governing bodies, their officials and public associations.</p> <p>Art. 6 ¶ 8 also provides that the President could terminate a Commissioner based on a vote of no confidence by Verkhovna Rada.</p>